ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: **Hollingsworth**	Analyst: **Kimberly Pantoja**	Bill Number:	**AB 1413**
Related Bills: **See Legislative History**	Telephone: **845-4786**	Introduced Date:	**02/23/01**
	Attorney: **Patrick Kusiak**	Sponsor:	

SUBJECT: Research Expenses Credit/Increase Federal Alternative Incremental Credit Percentages

SUMMARY

This bill would increase the alternative incremental research expense credit to equal the prior federal credit percentages as they existed on January 1, 1998.

PURPOSE OF THE BILL

According to the author's staff, the intent of the bill is to increase the percentages of the state credit for alternative incremental research expenses to be in conformity with the current federal percentages.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The increased percentage for the credit would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are provided to address the department's implementation and technical concerns.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows taxpayers a research credit that is combined with several other credits to form the general business credit. The research credit is designed to encourage companies to increase their research and development activities.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Alan Hunter for GHG	05/10/01
_____ N	_____ OUA	__X__ PENDING		

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be conducted in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1.   Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.

2.   Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.

3.   The application of the research must be intended for developing a new business component. This is a product, process, technique, formula, or invention to be sold, leased, or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved.

Taxpayers may elect to compute the research credit using the alternative incremental credit. The credit is equal to the sum of an increasing percentage of the amount of qualified research expenses in excess of a percentage of the base amount. The base amount is the average gross receipts for the last four tax years.

♦ 2.65% of qualified research expenses in excess of 1% of base amount but not more than 1.5% of the base amount.
♦ 3.2% of qualified research expenses in excess of 1.5% of base amount but not more than 2% of the base amount.
♦ 3.75% of qualified research expenses in excess of 2% of base amount.[1]

California conforms to the federal credit with the following modifications:

♦ The state credit is not combined with other business credits.
♦ Research must be conducted in California.
♦ The credit percentage for qualified research in California is 15% versus the 20% federal credit.
♦ The credit percentage for basic research in California, limited to corporations, is 24% versus the 20% federal credit.
♦ The percentages for the alternative incremental research portion of the credit are 90% of the federal percentages as they existed on January 1, 1998 (1.65%, 2.2%, and 2.75%) or 1.49%, 1.98%, and 2.48%, respectively.

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent.

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[1]   The federal rates were increased for taxable years beginning on or after June 30, 1999. The previous rates were 1.65%, 2.2% and 2.75% respectively.

THIS BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would increase the state alternative incremental research expense credit to equal the federal credit percentages on January 1, 1998. Thus, the federal percentages on January 1, 1998, of 1.65%, 2.2%, and 2.75%, would apply for state purposes.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the current state alternative incremental research expense credit percentages only to the federal credit percentages on January 1, 1998, because the state is in conformity with the federal law as of that date. The author has indicated that the intent is for the state to be in conformity with the current federal percentages of 2.65%, 3.20%, and 3.75%. Amendments 1 through 4 are provided to resolve this concern.

Implementation of this bill would occur during the department's normal annual system update.

TECHNICAL CONSIDERATIONS

Amendments 5 and 6 are provided to correct references from "income" year to "taxable" year.

LEGISLATIVE HISTORY

AB 660 (Nakano, 2001/2002) contains similar language as this bill and is currently in the Assembly Revenue and Taxation Committee.

SB 1165 (Brulte, 2001/2002) and AB 483 (Harman, 2001/2002) would increase the credit for qualified research expenses from 15% to 20%; these bills are currently in the Revenue and Taxation Committees of their respective houses.

AB 465 Nakano (Stats. 2000, Ch. 103) increased the state alternative incremental research expense credit to 85% of the prior federal amount, instead of the existing 80%.

AB 68 (Cunneen, 1999/2000), AB 1953 (Cunneen, 1999/2000), AB 2592 (Campbell, 1999/2000), SB 1495 (Brulte, 1999/2000), and SB 2200 (Dunn, 1999/2000) would have increased the qualified research expense credit percentage and would have decreased the minimum threshold for computing the credit. AB 68 failed to pass out of the Assembly by January 31 of the second year, AB 1953 was held in Assembly Appropriations Committee, AB 2592 was held in the Assembly Revenue and Taxation Committee, and SB 1495 and SB 2200 were held in the Senate Revenue and Taxation Committee.

SB 705 Sher (Stats. 1999, Ch. 77) increased the state credit for qualified research expenses from 11% to 12%.

OTHER STATES' INFORMATION

The laws of the following states were reviewed because their tax laws are similar to California's income tax laws.

Florida excludes from the payroll factor for apportionment purposes compensation attributed to Florida that is dedicated exclusively to research and development activities performed pursuant to sponsored research contracts with a state university or certain nonpublic universities. This exclusion is for corporate income tax purposes only as Florida does not have a personal income tax.

Illinois corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in Illinois. The credit equals 6 1/2% of the qualifying expenditures.

Massachusetts corporate taxpayers, but not individuals, may claim an income tax credit for qualified expenditures that are used for increasing research activities in Massachusetts. The credit is 15% of the basic research expenses and 10% of qualified research expenses conducted in Massachusetts.

Michigan, Minnesota, and *New York* do not allow a research credit.

FISCAL IMPACT

This bill is not expected to impact the department's costs significantly.

ECONOMIC IMPACT

Tax Revenue Estimate

This bill would result in revenue losses as follows:

Estimated Revenue Impact of AB 1413 As Introduced February 23, 2001 $ Millions			
2001-02	2002-03	2003-04	2004-05
-$30	-$49	-$63	-$69

The revenue estimate was calculated based on the author's intent to increase the state percentages to the current federal percentages. Specifically, the California credit percentages would be raised from the current level of 1.49%, 1.98%, and 2.48% to 2.65%, 3.20%, and 3.75% respectively.

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Estimate Discussion

The above revenue impact was estimated as follows. First, the revenue loss due to the alternative incremental research credit under existing B&CTL was estimated for 1994 using the department's corporate samples as well as other corporate financial data. Next, the revenue loss due to the alternative incremental research credit under the proposed higher credit rates was estimated using the same data. The difference between these two amounts was the bill's B&CTL revenue impact.

The estimated 1994 revenue losses were extrapolated to future years using reported aggregate research credit claimed by California corporations from 1994 to 1998, and Department of Finance projected annual growth rates of corporate profits. Finally, the revenue impact under PITL was assumed to be equal to 4.8% of the B&CTL impact and was added to the corporate impact.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1413
As Introduced February 23, 2001

AMENDMENT 1

On page 3, line 29, after "Code," insert:

as amended by P.L. 106-170,

AMENDMENT 2

On page 3, line 30, strike "apply." and insert:

apply, except as otherwise provided.

AMENDMENT 3

On page 7, line 22, after "Code," insert:

as amended by P.L. 106-170,

AMENDMENT 4

On page 7, line 23, strike "apply." and insert:

apply, except as otherwise provided.

AMENDMENT 5

On page 8, line 6, strike "income" and insert:

taxable

AMENDMENT 6

On page 8, line 8, strike "income" and insert:

taxable